

Message Text

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TO SECSTATE WASH DC PRIORITY 5091
INFO AMEMBASSY LONDON
AMEMBASSY JIDDA
AMCONSUL DHARAHAN
AMEMBASSY KUWAIT
AMEMBASSY TEHRAN
AMEMBASSY THE HAGUE

C O N F I D E N T I A L SECTION 01 OF 03 OECD PARIS 02796

E.O. 11652: GDS
TAGS: ENRG, OPEC, OECD
SUBJECT: IEA: SOM - SHELL'S OIL MARKET ASSESSMENT

1. IN JANUARY 24 CONSULTATIONS WITH IEA STANDING GROUP ON THE OIL MARKET, SHELL REPS PRESENTED MARKET OUTLOOK UNDER TWO TIER PRICE SYSTEM, DETAILS ON IMPACT ON SHELL CRUDE SOURCING AND POSSIBLE OPEC OUTCOMES AND IMPLICATIONS. SHELL IS HEAVILY DEPENDENT ON UPPER TIER OPEC OIL. SINCE IT EXPECTS LOWER TIER OPEC OIL TO EXERT STRONG DOWNWARD PRODUCT PRICE PRESSURE, PARTICULARLY IN EUROPE, SHELL FERVENTLY HOPES FOR A QUICK OPEC COMPROMISE ON A SINGLE MARKET PRICE BUT IN MEANTIME IS MAKING STRONG SHIFTS IN LIFTING PATTERNS AMONG PERSIAN GULF PRODUCERS.

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2. DEMAND FORECAST. SHELL FORECASTS 1977 TOTAL FREE WORLD OIL DEMAND AT 50.1 MMBD, AS COMPARED WITH 48.1 MMBD IN 1976 AND 48.7 MMBD IN RECORD YEAR 1973. L CRITICAL ASSUMPTIONS OF THE ESTIMATE ARE THAT OECD 1977 GNP/GDP GROWTH WILL BE LOWER THAN 1976 (4.5 PERCENT VS. 5.5 PERCENT IN 1976) AND OECD INDUSTRIAL PRODUCTION WILL ALSO GROW MORE SLOWLY (6 PERCENT VS 7.5 PERCENT IN

1976). BY AREA, OIL DEMAND WILL GROW AS FOLLOWS:
NORTH AMERICA FROM 20.0 IN 1976 TO 20.9 MMBD IN 1977,
CONTINENTAL EUROPE FROM 12.0 TO 12.3 MMBD, UK/IRELAND
1.8 MMBD UNCHANGED, JAPAN FROM 5.1 TO 5.4 MMBD, REST OF
WORLD FROM 7.9 TO 8.2 MMBD AND OIL INDUSTRY USES FROM
1.3 TO 1.5 MMBD IN 1977.

3. SUPPLY. SHELL PRESENTED ITS PRE-DOHA AND POST-DOHA
FREE WORLD SUPPLY ESTIMATES (MMBD). POST-DOHA ESTIMATE
ARBITRARILY ASSUMES RESOLUTION OF TWO TIER PRICE
ISSUE AT MIDYEAR.

SOURCE	1976	1977	1977
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OPEC

SAUDI ARABIA (N.Z.)	8.7	8.2	9.8
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UAE

KUWAIT (N.Z.)	2.1	2.5	1.7
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IRAQ

IRAN

OTHER OPEC	9.7	9.7	9.4
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NORTH AMERICA	12.3	12.7	12.7
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NORTH SEA	0.5	1.4	1.5
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OTHER NONOPEC	3.9	4.3	4.4
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TOTAL

SHELL BREAKS OUT ABOVE SUPPLY ESTIMATES BY
QUARTER AS FOLLOWS:

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SOURCE	1Q	2Q	3Q	4Q
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SAUDI ARABIA	10.3	10.8	8.7	9.3
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UAE

KUWAIT	1.5	1.4	2.1	2.1
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IRAQ

IRAN

OTHER SOURCES	26.6	27.5	28.3	29.8
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STOCK (BUILD)/DRAW	3.5	(2.3)	(3.2)	(0.6)
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4. OUTCOME AND IMPLICATIONS. IN SHELL'S VIEW, THE TWO
TIER MARKET CANNOT LAST. THE MARKET WILL FORCE AN
EQUILIBRIUM PRICE AMONG PERSIAN GULF CRUDES IF OPEC
DOES NOT ESTABLISH ONE. OPEC IS PROBABLY UNABLE TO
AGREE ON PRODUCTION PRORATIONING OR ON A FIXED SYSTEM
OF DIFFERENTIALS. HOWEVER, IT REMAINS IN OPEC'S
INTEREST NOT TO ALLOW A REDUCTION IN THE BASIC PRICE OF
OIL WHICH IS WHAT WOULD HAPPEN IF OPEC COLLAPSED. IN

PRACTICE EVEN THE SAUDI POSITION DOES NOT EXTEND TO AN

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OUTRIGHT REDUCTION IN BASIC PRICE.

5. SHELL BELIEVES THE AFRICAN, FAR EAST AND LATIN AMERICAN CRUDES WILL RETAIN THEIR MARKETS UNDER THE TWO TIER SYSTEM AND THAT INCREMENTAL PRODUCTION OF SAUDI HEAVY CRUDE WILL FIND A READY MARKET SOMEWHERE. THUS THE BURDEN OF REDUCTION IN VOLUME TO BALANCE THE SAUDI INCREASES WILL FALL ON IRAN, IRAQ AND KUWAIT. IN FIRST QUARTER 1977, THIS SHIFT WILL AMOUNT TO ABOUT 4 MMBD AS A RESULT OF STOCK DRAWDOWNS AND INCREASED SAUDI SALES. KUWAIT CAN TOLERATE A REDUCTION TO ABOUT 1 MMBD, A MINIMUM TECHNICAL REQUIREMENT. IRAQ IS UNLIKELY TO TOLERATE A REDUCTION BELOW 2.0 MMBD BEFORE ENGAGING IN PRICE SHAVING TO ACQUIRE NEEDED REVENUES. IRAN IS CAST IN THE WHOLLY UNACCUSTOMED ROLE OF SWING

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PRODUCER FOR OPEC IN THE TWO TIER MARKET. ITS LEVEL OF PRODUCTION THUS BECOMES A FUNCTION OF SAUDI PRODUCTION, GLOBAL DEMAND (INCLUDING STOCK CHANGES), NON OPEC PRODUCTION AND KUWAITI AND IRAQI EXPORT LEVELS. MARKET PRESSURES ARE LIKELY TO BE SUCH THAT AN EQUILIBRIUM PRICE WILL EMERGE BY MID YEAR. HOWEVER, EMOTIONAL COMMITMENT COULD CREATE THE WILL POWER TO PROLONG THE TWO TIER SYSTEM WELL BEYOND.

6. SHELL BELIEVES A FULL RANGE OF OUTCOMES IS POSSIBLE:
A) A NEGOTIATED OPEC COMPROMISE, IN SHELL'S VIEW MOST DESIRABLE FOR LONG-TERM STABILITY AND GOODWILL AND WITH THE VIRTUE THAT IT COULD COME ABOUT QUICKLY WITHOUT LEAVING BITTERNESS; B) A MARKET FORCED COMPROMISE PRICE FOR PERSIAN GULF CRUDES; C) A WIN BY SAUDI ARABIA; OR D) A WIN BY THE ELEVEN. IN EITHER OF THE LATTER TWO CASES THE OUTCOME WOULD BE DISGUISED, E.G., THE SAUDIS COULD BLAME LACK OF PROGRESS IN CIEC OR IN A MIDEAST SETTLEMENT IF THEY DESIRED. SHELL BELIEVES A SECOND STAGE INCREASE OF FIVE PERCENT ON JULY 1 WILL OCCUR ONLY IF THE ELEVEN HAVE WON OR IF THIS INCREASE IS INCLUDED IN A COMPROMISE AGREEMENT WITH SAUDI ARABIA. THUS SHELL DOES NOT NOW PREDICT ANTICIPATORY CRUDE BUYING IN THE SECOND QUARTER. SHELL CAN ENVISION AN EXTRAORDINARY MEETING OF OPEC ONLY IF IT IS FOR THE PURPOSE OF ENDORSING A COMPROMISE AGREED BEFOREHAND. AN EXTRAORDINARY MEETING OF THE ELEVEN WOULD ONLY MAKE SENSE IF IT RESULTED IN PRODUCTION PRORATIONING. BUT IT IS DOUBTFUL THAT THE REQUISITE MUTUAL TRUST EXISTS AMONG THE ELEVEN OR AMONG THE MOST AFFECTED GULF PRODUCERS. AN AGREEMENT AMONG THEM ON PRORATIONING IS CONCEIVABLE ONLY IF IT INCLUDES A FURTHER PRICE INCREASE WHICH THEY PERCEIVE AS SUSTAINABLE.

7. ONE SAUDI OBJECTIVE IS TO EXPAND ITS ABILITY TO
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CONTROL DECISIONS ON OPEC PRICING BY INCREASING INSTALLED CAPACITY AND FOR THIS PURPOSE IT HAS APPARENTLY DUSTED OFF CAPACITY EXPANSION PLANS THAT WERE ANNOUNCED BEFORE THE 1973 EMBARGO. THUS, IT CAN EMERGE STRONGER WITHIN OPEC IN THE FUTURE REGARDLESS OF THE OUTCOME OF THE TWO-TIER PRICE SYSTEM. IN SHELL'S VIEW, HOWEVER, THIS WILL ONLY MAKE MORE OBVIOUS THE SAUDI CONTROL OVER THE REVENUE POTENTIAL OF THE REST

OF OPEC AND WILL ACCORDINGLY BRING SAUDI ARABIA UNDER GREATER PRESSURE FROM THEM. THIS IMPLIES FUTURE UPSIDE PRICE RISK, ESPECIALLY IF WESTERN DEMAND FOR OIL INCREASES AND GLOBAL ECONOMIC RECOVERY IS STRONG.

8. ADMITTING SHELL'S COMMERCIAL INTEREST IN A QUICK OPEC COMPROMISE, REPS ARGUED THAT THIS IS IN THE GENERAL INTEREST SINCE IEA COUNTRIES WILL CONTINUE TO BE DEPENDENT UPON BOTH FACTIONS IN OPEC. SHELL CAUTIONED THAT ANY IEA ACTION OR OBSERVATION IN THIS PERIOD COULD BE OFFENSIVE TO ONE SIDE OR THE OTHER AND THAT IEA SHOULD BEHAVE CIRCUMSPECTLY AND HOPE THE SITUATION IS TEMPORARY. AT THE SAME TIME, SHELL MAINTAINED THAT IT AND OTHER COMPANIES WILL PLAY A ROLE IN DRIVING RELATIVE OPEC PRICES DOWNWARD AND THAT GOVERNMENTS SHOULD CONCENTRATE THEIR ACTIONS AND DIPLOMACY ON FACTORS AFFECTING BASIC OPEC PRICE LEVELS.

9. SHELL REPS STATED CURRENT COMPANY STRATEGY IS TO MAXIMIZE ITS AVAILABILITY OF 5 PERCENT CRUDES, DRAW DOWN STOCKS TO HOLD DOWN LIFTINGS OF KUWAITI AND IRANIAN CRUDES IN PARTICULAR. SHELL PRESENTED TABLE OF 1976 LIFTINGS (WHICH UNDERSTATE HIGH 4Q 1976 LIFTING LEVELS) AND EXPLAINED PRINCIPAL CHANGES IN JANUARY LIFTINGS.

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SHELL 1976 LIFTINGS

SAUDI ARABIA 33 MBD

UAE 169 MBD

KUWAIT 329 MBD

IRAQ 149 MBD

QATAR 214 MBD

IRAN 746 MBD

NIGERIA 427 MBD

VENEZUELA 308 MBD

OTHER OPEC 135 MBD

NON OPEC

OMAN 252 MBD

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NORTH SEA 35 MBD

FAR EAST 341 MBD

OTHER 505 MBD

TOTAL SHELL 3643 MBD

IN JANUARY 1977, SHELL WILL EXPAND LIFTINGS OF SAUDI ARABIAN CRUDE TO ABOUT 100 MBD AND EXPECTS THIS AVAILABILITY TO INCREASE TO 200 MBD OVER THE YEAR. REPS SAID THIS ACCESS ARISES FROM INITIAL APPROACHES THROUGH SAG FOLLOWED BY APPROACHES THROUGH PETROMIN (AND MENTIONED NO ROLE OF ANY ARAMCO PARTNER IN TRANSACTION). ON THE OTHER HAND, REPS SAID TWO-TIER PRICE SYSTEM IS CREATING DIFFICULTIES IN CONTINUATION OF LONGSTANDING 50 MBD CRUDE EXCHANGE ARRANGEMENT WITH AN ARAMCO PARTNER. SHELL CONFIRMED REDUCTION IN ITS JANUARY KUWAITI LIFTINGS TO CONTRACTUAL MINIMUM OF 260 MBD. IT IS HOLDING IRAQI LIFTINGS TO 200 MBD, THE MINIMUM LEVEL ALLOWED UNDER LONG TERM CONTRACT WHICH CALLS FOR AN ANNUAL INCREASE IN LIFTINGS. MOST OTHER LIFTINGS ARE LITTLE CHANGED, E.G., NIGERIA 400 MBD, VENEZUELA 300 MBD, OMAN 230 MBD, QATAR 200 MBD, NORTH SEA 100 MBD, FAR EAST 340 MBD. SHELL WILL BALANCE THE REQUIREMENTS OF ITS GLOBAL SYSTEM IN JANUARY BY REDUCTIONS IN LIFTINGS FROM IRAN TO 550 MBD.

10. REPS SAID THAT SHELL HAS EXPLAINED TO KUWAIT AND

IRAN WHAT IT IS DOING AND WHY. THEY SAID THAT THEIR STRATEGY WILL CREATE DIFFICULTIES WITH THESE PRODUCERS OVER THE LONG TERM BUT IN THE SHORT TERM SHELL CAN TAKE ADVANTAGE OF CONTRACTUAL FLEXIBILITIES OR, IN THE CASE OF IRAN, OF THE ABSENCE OF FIRM LIFTING COMMITMENTS, AND WILL DRAW DOWN STOCKS. RE IRAN CONSORTIUM, REPS STATED CAREFULLY THAT CONSORTIUM HAS NOT MET "FORMALLY" WITH THE GOI, THAT SHELL DOES NOT HAVE INFORMATION ON WHAT THE CONSORTIUM "AS A WHOLE." MAY

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PLAN FOR LIFTINGS AND THAT 'AS OF JANUARY 20 EACH MEMBER WAS FOLLOWING HIS OWN PARTICULAR LINE.'

11. SHELL ALSO PRESENTED FIGURES TO SUPPORT ITS CLAIM OF DIFFICULT COMPETITIVE SITUATION. EXCLUDING NORTH AMERICAN AND COMMUNIST PRODUCTION, SHELL MAINTAINED THAT ITS AVERAGE CRUDE COSTS IN 1Q 1977 WILL INCREASE \$1.06/BBL (BASED ON AVAILABILITIES OF 400 MBD FIVE PERCENT CRUDE, 2.2 MMBD TEN PERCENT CRUDE AND 720 MBD OTHER CRUDE) WHILE INDUSTRY-WIDE INCREASE WILL AVERAGE \$0.93/BARREL. SOME COMPANIES WILL BE WELL BELOW THE INDUSTRY AVERAGE. ON BASIS OF A REPRESENTATIVE INDUSTRY REFINING/MARKETING EXAMPLE IN EUROPE, SHELL CALCULATED A \$0.30 COMPANY MARGIN PER BARREL IN 1976, REPRESENTING A \$0.20 MARGIN DOWNSTREAM AND A \$0.10 MARGIN UPSTREAM. SHELL PROJECTED A POTENTIAL MINUS \$0.20 SHIFT IN THE DOWNSTREAM MARGIN AS A RESULT OF INCREASED AVERAGE CRUDE COSTS AND THE INFLUENCE OF FIVE PERCENT CRUDE ON PRODUCT PRICES AND PREDICTED THAT THERE WOULD BE SUBSTANTIAL MARKET SHARE SHIFTS AMONG COMPANIES IN A PROLONGED TWO-TIER CRUDE MARKET.

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